26 June 2013

K3 BUSINESS TECHNOLOGY GROUP

SOFTWARE & COMPUTER SERVICES

KBT.L

109.5p

Market Cap: £32m

SHARE PRICE PERFORMANCE

12m high/low

Source: LSE Data

KEY INFORMATION

Enterprise value	£47m
Index/market	FTSE AIM
Next news	FY13 – mid Sept
Gearing	55%
Interest cover	6.2x

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VERGING ON VINDICATION…?

FY13 below plan, but spending on Gemstone starts to look well timed

K3 has published an ostensibly disappointing trading update, with FY13 results (to June) likely to be "below current market forecasts". We make appropriate changes to our estimates as detailed overleaf, with the new forecasts summarised below.

There are, however, some material positives – a strong win-rate has been experienced in UK Retail in particular over the final quarter, mainly as customers begin to spend on new solutions following the Gemstone initiative. As we highlighted in March, the pain of this investment is being felt before the positives associated with software licences and (later) managed services. Although the group has not converted enough of these deals in time for the year-end, K3 could be on the brink of a major rebound in fortunes.

- K3 is, as we highlighted in our note "No Pain – No Gain" on 12 March 2013, suffering from the twin effects of increased investment in software development and decreased revenues as customers defer spend in the difficult macro-economic environment. The lack of reference sites for the Gemstone AX product has also, arguably, held back early customer uptake.

- Ironically, just as the group has been forced to accept that FY13 win rates are insufficient to reach consensus estimates, there has been a significant flow of order wins. The revenue recognition (in part due to customer choices over project phasing) does not allow material booking of sales and profits in FY13, but this clearly bodes well, both for software licences and long-term managed services revenues in FY14 and beyond.

Clearly, the FY13 shortfall is disappointing, but the SYSPRO and Sage division appears to be performing well, and Managed Services should see growth accelerate once Retail customers have installed software and move into the hosting and support phases of their projects. Full year results are due in mid-September, at which time we would hope for further news on Gemstone wins to further evidence the recovery.

FYE JUNE	2011	2012	2013E	2014E
Revenue	52.8	68.0	64.4	71.5
Adjusted EBITDA	10.6	12.9	6.8	9.8
Adjusted PBT	8.7	10.0	3.7	6.9
Adjusted EPS	22.8	24.4	9.1	16.8
EV/Sales	0.9x	0.7x	0.7x	0.7x
EV/ Adj. EBITDA	4.4x	3.6x	6.9x	4.8x
P/E	4.8x	4.5x	11.9x	6.5x

Source: Progressive Equity Research Limited forecasts

Changes to forecasts

We reduce our forecasts for FY13 from adusted EBITDA of £9.6m on revenues of £68.7m to adjusted EBITDA of £6.8m on revenues of £64.4m. The impact on adjusted PBT and EPS is similar to the change in EBITDA.

For FY14, we reduce our overall revenue figure by £1m from £72.5m to £71.5m (although the company would suggest that no reduction is necessary). We also reduce our EBITDA figure, from £11.9m to £9.8m, partly due to the lower revenue outlook, but also on the basis of reduced margins as the sales mix may contain fewer high-margin software licences.

We hope that these changes (especially the FY14 downgrades) prove to be overly cautious, but given the ongoing difficulties in predicting any recovery in retailers' spend, we choose to take the more prudent view. Notably, we are not assuming any double-benefit of licence revenues in FY14; we assume a "normal" year of some licence sales, and not a year filled with licences originally scheduled for FY13 and those planned for FY14. Again, we hope this assumption will prove cautious in time, but for now it feels the right course of action.

Additional comment

There are a number of points which should be made in relation to the group's current position which, in our view, is much stronger than it may appear on the basis simply of a FY13 revenue (and profit) shortfall :

The group is seeing a number of large order wins.

Phasing is being impacted by decisions to take projects in small phases.

- Retail AX demand, on the back of Gemstone, IS beginning to re-emerge, and to do so in some significant volume. Customers are, perhaps naturally, reluctant to commit to full roll-outs. Their preference for staged implementation is understandable, but has led to the FY13 shortfall. It does not, barring any unforeseen changes in plan, mean that they will choose other providers or cancel the remainder of the installation. This bodes well, both for later stage software licences (which may also fall in FY14) and for managed services revenues as the customers move into the support and hosting stages post the go-live of all modules.

Other areas of Retail are improving…

- We understand that both Retail NAV and Pebblestone (Dutch wholesale retail software) are performing better than in previous periods. This, combined with the nascent recovery in UK Retail AX, could lead to a material rebound in Retail divisional performance.

… and Managed Services should benefit in due course.

- Managed Services, in addition to the eventual "arrival" of the Retail customers currently in early stages of rollout, should begin to see benefit from the SYSPRO International hosting arrangements, with a number of potential major contracts in the pipeline. This has taken some time, but, as with Retail, may be about to bear fruit.
- The group is, as one would expect, ensuring that costs are being rationally controlled. This has already manifested itself in a number of ways across the different units, and management are keen to ensure that all expenditure is scrutinised in light of the emerging (and changing) customer spend propensities.

Overall, while the pendulum has swung quite far in the "not enough licences" direction, it may be already swinging back. The group is, finally, beginning to see a return on its investment, and although the investment has been a one-off material application of capital, the returns will be multiple in type, long in duration and high in value.

FINANCIAL FORECASTS

Year ended Jun	FY-10	FY-11	FY-12	FY-13	FY-14
	£m	£m	£m	£m	£m
Profit & Loss	Act	Act	Act	Est	Est
Revenue £m	43.8	52.8	68.0	64.4	71.5
Adj EBITDA £m	8.3	10.6	12.9	6.8	9.8
Adj EBIT £m	7.5	9.6	11.4	4.9	7.8
Reported PBT	4.4	4.9	6.0	-0.3	2.9
PBT before exceptionals and AAG	6.5	8.7	10.0	3.7	6.9
Fully adj PBT	6.6	8.7	10.1	3.8	7.0
NOPAT £m	5.2	6.7	8.0	3.4	5.4
Reported EPS	9.5	16.7	19.8	-0.7	7.1
EPS before exceptionals and AAG	18.3	22.7	24.3	9.0	16.6
Fully adj EPS	18.6	22.8	24.4	9.1	16.8
Dividend per share p	0.5	0.8	1.0	1.1	1.2
Cash flow & Balance sheet					
Operating cash flow	6.8	5.6	7.3	5.8	8.8
Free Cash flow £m	4.2	2.4	3.6	1.0	4.2
FCF per share p	16.7	8.9	12.4	3.4	14.4
Capex	-1.0	-2.1	-3.2	-3.2	-2.5
Acquisitions	-2.9	-5.4	-7.1	-1.3	-0.4
Net cash flow	0.8	-4.2	-5.4	-1.9	2.9
Shares issued	1.4	0.2	5.0	2.7	0.0
Net cash	-11.0	-15.5	-15.7	-14.9	-12.0

Metrics	FY-10	FY-11	FY-12	FY-13	FY-14
Revenue growth	*20.3%*	*20.4%*	*28.7%*	*-5.3%*	*11.1%*
Adj EBITDA growth	*11.5%*	*27.4%*	*22.4%*	*-47.6%*	*44.0%*
Adj EBIT growth	*13.8%*	*28.8%*	*18.4%*	*-57.2%*	*59.0%*
Adj PBT growth	*28.4%*	*31.5%*	*15.7%*	*-62.5%*	*84.1%*
Adj EPS growth	*24.1%*	*22.7%*	*7.2%*	*-62.6%*	*84.1%*
Dividend growth	*0.0%*	*50.0%*	*33.3%*	*10.0%*	*9.1%*
Adj EBIT margins	*17.1%*	*18.2%*	*16.8%*	*7.6%*	*10.9%*
Operating cash conversion	82%	53%	56%	85%	90%
Capex/Depreciation	126%	218%	206%	168%	125%

Valuation	FY-10	FY-11	FY-12	FY-13	FY-14
EV/sales	1.0	0.9	0.7	0.7	0.6
EV/EBITDA	5.1	4.4	3.6	6.8	4.4
EV/NOPAT	8.0	6.9	5.9	13.4	7.9
PER	5.9	4.8	4.5	11.9	6.5
Dividend yield	0.5%	0.7%	0.9%	1.0%	1.1%
FCF yield	15.3%	8.2%	11.4%	3.1%	13.2%

Source: Progressive Equity Research Ltd estimates

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